No. 15340

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

ELGIN R. PARKER,

Appellant,

vs.

HARRY C. WESTOVER, Individually and as former Collector of Internal Revenue for the Sixth District of California,

Appellee.

FLO PARKER,

Appellant,

vs.

HARRY C. WESTOVER, Individually and as former Collector of Internal Revenue for the Sixth District of California,

Appellee.

ELGIN R. PARKER,

Appellant,

vs.

R. A. RIDDELL, District Director of Internal Revenue, Los Angeles, California,

Appellee.

FLO PARKER,

Appellant,

vs.

R. A. RIDDELL, District Director of Internal Revenue, Los Angeles, California,

Appellee.

Appeal From the United States District Court for the Southern District of California, Central Division.

BRIEF FOR THE APPELLANTS.

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Opinion Below.

The opinion of the United States District Court for the Southern District of California, Central Division, is reported at 144 Federal Supplement 933, and is found in the Record at page 31.

Jurisdiction.

These appeals involve federal income taxes. The taxes in dispute were paid by the appellants, Elgin R. Parker and Flo Parker. The taxes for 1945 and 1946 were paid to the Collector of Internal Revenue for the Sixth District of California and for 1947 and 1948, to the District Director of Internal Revenue for Los Angeles, California.

The proceeding involves gross claims for refunds as follows:

Year	*Elgin R. Parker*	*Flo Parker*
1945	$55,682.54	$56,177.58
1946	$69,631.37	$69,631.38
1947	$ 2,825.67	$ 2,811.57
1948	$10,933.83	$10,669.45

[R. 5, 13, 20, 24.]

The *net* amounts involved are the amounts of the claims for refund, less the amounts that will be re-collected from appellants' four children as their income taxes for the same years, if the children are held to be partners for income tax purposes. [R. 53, pars. XIII, XIV.]

Federal Income Tax returns for each year were timely filed by the appellants and the taxes shown to be due thereon were paid. Subsequently the Commissioner of Internal Revenue proposed additional taxes for each of said years. The appellants paid the said proposed additional taxes and filed timely and proper claims for refund therefor. Said claims were rejected by the Commissioner of Internal Revenue and these suits followed. [R. 5, 6, 13, 20, 24.]

The judgments were entered July 12, 1956 and the notices of appeal were filed on August 13, 1956. [R. 57.]

Jurisdiction was conferred on the District Court by 28 U. S. C., Section 1340. Jurisdiction is conferred on this Court by 28 U. S. C., Section 1291.

Question Presented.

Where appellants gave to their four children half of the assets in a business, and the Superior Court appointed a guardian and authorized him to enter into a general partnership agreement with appellants for the carrying on of that business, and capital was material in the operations of that business and provided all the income remaining after an adequate salary had been paid to appellant Elgin R. Parker, and the children, through the guardian and Superior Court, controlled their interests and enjoyed their income and assets, did the District Court correctly ignore the children as partners and tax appellants on the children's incomes?

Statutes Involved.

The statutes involved in this proceeding are set out in the Appendix.

Statement of the Case.

Facts Relating to Motive.

This partnership arose out of a bitter experience had by appellants in 1936. Prior to 1930, they had a water heater manufacturing business which had always made profits for them. [R. 58, 59, 86.] From 1930 to 1937. Mr. Parker worked as an executive for another water heater manufacturer. [R. 59.] In 1936 they were thrown into bankruptcy by large real estate debts and obligations which became due in and after the depression when real estate values had dwindled to but a small per-

centage of their original prices. [R. 59.] The real estate operations had been a side line with appellants. [R. 59.]

After being discharged from bankruptcy, Elgin R. Parker continued to work for other water heater manufacturers for a time [R. 59], and then by virtue of savings and a gift from a relative, he again bought the Southern Heater Company, partly on credit [R. 86], and by 1943 had built up a profitable business. [R. 59, 71.]

Mr. and Mrs. Parker were determined to give some security to their children as soon as possible so that the children would have some means of support should the parents again get into straitened financial circumstances. [R. 60.]

In addition to desiring to give the children some security, the appellants hoped that eventually the children would grow up and remain in the business and provide successor management for it. [R. 61.]

On October 31, 1943, each appellant owned as his or her separate property a one-half interest in a partnership known as Southern Heater Company. [R. 59.] Elgin R. Parker managed the business from which he took a salary of $12,000 a year. [R. 64.]

This business was the only asset of any consequence appellants had at that time. It was making substantial profits and, although the war made it difficult to obtain materials, there was a reasonable expectation that the business would continue to be profitable. [R. 68, 69, 71, 86.] In fact, the Commissioner of Internal Revenue determined that the business had a valuable good will, and imposed gift taxes on the October 31, 1943 gift of the good will hereinafter described. [R. 7, par. XII, R. 21, par. XII.]

As of October 31, 1943, each appellant gave to each of his or her four children a six and one-quarter per cent interest in the business. The gifts were represented by deeds which were absolute and unconditional and did not depend in any way on whether the children left their shares of the assets in the business, whether the children entered into a partnership with the donors, or whether the assets given them were sold and the proceeds invested in securities. [R. 94, 117; Pltf. Exs. 1 and 2.]

After making the gifts, Elgin R. Parker applied to the Superior Court of Orange County, in which County the family was then living, for appointment of himself as guardian of the persons and estates of the children so that they would have someone to look after their assets, under the supervision of the court. [R. 96, Pltf. Ex. 11.] The court appointed Mr. Parker as guardian provided he file four corporate surety bonds of $23,000 each which was approximately the cost of the assets given to each child. Eventually the bonds were written and filed, whereupon Elgin R. Parker was appointed guardian. [R. 96, Pltf. Ex. 12.]

Articles of Co-partnership were prepared and presented to the court and approved and signed by the appellants for themselves individually and by Elgin R. Parker as guardian for the four children. [R. 121, Pltf. Ex. 3.] The partnership took effect as of November 1, 1943. [R. 94, par. 3.] The children contributed their assets to the capital of the partnership, for an interest of 50% in the capital and income of the partnership. [R. 122, Pltf. Ex. 3.] They provided for a general partnership and authorized a salary of $12,000 per year for Elgin R. Parker, subject to adjustment by written agreement of the partners. [R. 125, par. 10.] This was a reasonable salary.

[R. 64, 69, 70, 81, 82, 168, Pltf. Ex. 63.] The Commissioner of Internal Revenue used a salary of $12,000 in determining the value of the good will for gift tax purposes. [R. 7, par. XII, R. 21, par. XII.]

The partnership was organized to engage in the heater manufacturing business only, and not to engage in real estate transactions. [R. 121, par. 2.]

Under the California law, each partner had an equal voice in the management of the business and hence the Superior Court through the guardianships had four votes, as opposed to two for the appellants. (Cal. Corp. Code, Sec. 15018(e).)

Since November 1, 1943, the guardian has filed annual accounts with the court and has had such accounts approved and has operated and managed the guardianship investments and estates and the partnership under the supervision and jurisdiction and under the orders of the Probate Court. [R. 97-116, incl., Pltf. Exs. 3-59, incl.]

The partnership filed certificates of fictitious firm name [R. 95, Pltf. Ex. 6], and was otherwise created with all the necessary legal formalities and was held out as a partnership in all dealings with the tax authorities, the surety company, the Probate Court and the creditors. [R. 94-95, Pltf. Exs. 4-6.]

The appellant's objectives in making the gifts and creating the partnership have been in large part fulfilled. Each child has assets costing over $122,000 and each receives dividends from his or her stock averaging around $7,000 per year. [R. 113-115, Pltf. Exs. 56, 57.] The two

boys are still in school and are taking courses in Commerce and Engineering, respectively, which training would be helpful in the business. Though they are as yet undecided as to what they wish to do when they have completed their education, it seems quite reasonable to expect that one or both of them will enter the business as his lifetime career. [R. 63, 73, 89, 90, 91.]

Facts Relating to Business Purpose.

At the time of the gifts, the assets in the former partnership consisted of land and building, machinery, inventory, accounts receivable and cash. These aggregated around $311,000. [R. 163, 164, Pltf. Ex. 58.] All were absolutely necessary in the conduct of this business. [R. 60, 69, 71, 79.]

After the gifts, each parent owned a 25% interest in these assets and the children collectively owned a 50% interest therein. The current assets as of the date of the gift were about twice the current liabilities [R. 163, 164, Pltf. Ex. 58], which is a normal ratio for a manufacturing business. It was necessary to have cash on hand in order to buy steel when it became available and necessary to have considerable working capital to carry the accounts receivable, payrolls, taxes and other operating expenses. [R. 69.]

In order for the business to grow, it was necessary to retain in it most of the earnings, since Elgin R. Parker had a policy against borrowing money. [R. 69, 79.] The children's initial capital interests in the partnership aggregated about $99,000. [R. 165, Pltf. Ex. 60.] As a

result of their earnings and the retention of earnings in the business, their investments in the firm were as follows:

October 31, 1943	$ 98,983.92
October 31, 1944	$165,541.68
October 31, 1945	$217,671.76
October 31, 1946	$357,168.76
October 31, 1947	$302,371.00
October 31, 1948	$338,359.68

[R. 165, Pltf. Ex. 60.]

While the $99,000 initially contributed by the children came from gifts, the increases were the children's contributions of original capital. (*Parker v. Westover,* 221 F. 2d 603, 606.)

Capital was a material income-producing factor in the business. It produced all of the profits of the business after adequate salaries had been paid to the employees and Elgin R. Parker. [R. 60, 64, 69, 71, 79.]

As of May 1, 1946, the land and building were retained in the partnership but all of the other assets used in the heater business were transferred to two corporations in exchange for the stocks of those corporations. One company, the Southern Heater Corporation, took over the business of manufacturing water heaters, and the other company, the American Control Company, took over the business of manufacturing control equipment. [R. 98, 99, Pltf. Exs. 23, 25.] Thereafter the partnership reduced the salary of Elgin R. Parker to $200 instead of $1,000 per month [R. 95, Pltf. Ex. 8, R. 64], and henceforth the land and building were leased to Southern Heater Corporation for $30,000 per year, plus taxes, insurance and repairs. [R. 99, Pltf. Ex. 23.] In

September, 1948, the land and building were transferred into a third corporation, Parker Realty Company, in exchange for all its stock. [R. 100, 101, Pltf. Exs. 32, 34.]

From May 1, 1946, until the partnership was dissolved on October 31, 1948, the partnership was merely passive, owning stocks and until September, 1948, holding property under a long term lease. It paid an adequate salary to Elgin R. Parker for his nominal management duties and the remainder of the income from the partnership was obviously due to its capital. [R. 64.]

All of the income allocated to the minor partners was from their capital invested in the business.

Facts Relating to Reality of Ownership by the Children.

The gifts of interests in the business as of October 31, 1943, were irrevocable and unconditional. [R. 94, Pltf. Exs. 1 and 2.] The parents had no control over the children's property, as only a court-appointed guardian could control it. (Cal. Civ. Code, Sec. 202.)

Elgin R. Parker was appointed guardian [R. 96, 97, Pltf. Exs. 12, 15], and asked the court to allow the children's interests to remain in the business and to allow him, as guardian, to become a partner in the business. [R. 97, Pltf. Exs. 13, 14, 16, 17.]

The court could have refused these applications and required the children to sell their assets and invest them in government bonds or other low-yielding securities. Instead, the court approved the requests and authorized the guardian to enter into the partnership and to leave the assets in the business and to retain earnings in the business for future growth. [R. 97, Pltf. Exs. 13, 14.]

The partnership was a general partnership and each partner had authority to bind the business. [R. 97, Pltf. Exs. 16, 17.]

The partnership agreement provided that any partner could dissolve it at any time [R. 122, Pltf. Ex. 3, par. 4], or sell his interest at any time provided he gave the other partners the right for a limited period to acquire that interest for the offered price, upon the failure of which he could sell it to anyone. [R. 126, 127, Pltf. Ex. 3, par. 13.]

Distributions of income and payment of compensation to Mr. Parker were to be fixed by the vote of the partners. [R. 124, 125, Pltf. Ex. 3, pars. 8, 10.] The appellants did not have any rights that the other partners did not enjoy and there was no possibility for the appellants to take advantage of the children in any manner whatsoever. Elgin R. Parker, as a general partner, managed the business. He did this in a double fiduciary capacity—first as a general partner, and second as a guardian under the supervision of the court. He filed guardianship bonds and will be liable to the children upon their becoming of age in the event of wrongdoing. [R. 116, Pltf. Ex. 59.]

Books of account were opened by the partnership and the children's capital interests were set up therein and their shares of profit were credited to their accounts. [R. 88,]

When the partnership was dissolved as of October 31, 1948, each guardianship received its share of stocks of the three companies which held the land and building, the heater manufacturing business and the controls business, so that all of the earnings of the partnership were dis-

tributed at that time to the guardianships and the other partners. [R. 130, Pltf. Ex. 10.]

After the business was incorporated, the guardianships have received dividends from the stocks held by them. [R. 105, 106, 109, 113, 114.] The two older children, Flo Diane and Patricia, became of age in 1950 and 1953, respectively, and their guardianships were terminated and they received their shares of the assets free and clear of control by their parents. Each is married and has children. [R. 104, Pltf. Ex. 43, R. 109, 110, 66.]

The guardianships for the two minor sons are still under control of the court [R. 65], and when the boys become of age they will receive their share of assets free and clear of any control by the parents.

The parents continued to support the children as long as they were minors and did not use any of the children's funds for that purpose. [R. 68.] The appellants' economic status was reduced in half by the gifts to the children.

The partnership filed income tax returns, reporting income and showing the six partners and their distributive shares. [R. 70.] The children filed income tax returns, reporting their shares of the partnership income and paid taxes thereon. [R. 70.]

The children, through the guardian and under the supervision of the Probate Court, really and truly owned and controlled their property and their income and their interests in the partnership business.

The appellants filed gift tax returns as a result of the 1943 gifts and paid gift taxes thereon. [R. 63.] The Commissioner of Internal Revenue audited the returns and found that the gifts were irrevocable and complete,

and determined that the business had a valuable good will and increased the gift taxes due to the gift to the children of interests in the good will. Appellants paid the additional gift taxes and no refunds of any of these gift taxes have been made by the Commissioner or appellee. [R. 64.]

Specification of Errors.

1. The primary basis for the lower court's decision that there was no legitimate purpose for the gifts or the creation of the partnership, is contrary to the facts and evidence.

2. The lower court's finding of fact that the children contributed no capital, that capital was not a material income-producing factor and that all of the income of the business was produced by the services of Elgin R. Parker, is contrary to the facts and the evidence.

3. The lower court's finding of fact that the appellants continued to have sole control of the business and that the gifts and partnership did not change the control of the business, is contrary to the law and to the facts and the evidence.

4. The lower court erred in finding or holding that the gifts and partnership made no real change in the economic or financial status of the Parker family.

5. The lower court's finding that the parties did not intend to join together as partners, is not supported by any evidence, but is directly contrary to the uncontradicted evidence and is based upon the erroneous ultimate findings referred to above.

6. The trial court's finding that capital produced no income and that all income of the partnership was pro-

duced by the services of Elgin R. Parker, is doubly erroneous for the period after April 30, 1946, when the partnership became a passive property-holding enterprise.

Summary of Argument.

Under the Internal Revenue Code, income from property is taxable to the owner of the property and to no one else. Where capital is a material income-producing factor, the owner of a capital interest in a partnership is taxable on his distributive share of partnership income, after reasonable compensation has been paid to the partner who renders services to the partnership business.

All of those factors are present here. The lower court disregarded the uncontradicted evidence and the late decisions of this court and pronouncements of the Federal Legislative Committees and admissions against interest by the Commissioner of Internal Revenue. The lower court ignored the correct principles and demanded stricter requirements than the above authorities require, brushed aside capital as an essential factor and erroneously concluded that the services of Elgin R. Parker produced all the partnership income.

The lower court ignored this court's decisions on fiduciary control and liberalization of partnership requirements, and hence erred in its decision that the appellants did not make the children partners with a bona fide business purpose.

ARGUMENT.

I.

The Gifts Were Made and the Partnership Was Formed for a Legitimate Business Purpose.

The lower court's finding of fact on motive is set out in Finding No. XI which reads as follows:

> "Plaintiffs had no business purpose in making the deeds of gift to their children or in the creation of the general partnership. Plaintiffs' sole, expressed purpose was to help the children and to provide an inducement for the children to enter the business of the family. This expressed purpose is not credible and lacks foundation when considered in light of the fact that plaintiffs created a general partnership which rendered the entire interest of the children subject to claims of creditors and in light of the tender ages of the children during the period of the partnership involved herein. To this date none of the plaintiffs' children has actively entered into the business of the plaintiffs or even expressed a determination so to enter the business when he is of age." [R. 52.]

The uncontradicted testimony was that the earlier bankruptcy of the appellants had generated in them a strong desire to give some security to their children. (This brief, p. 4.) The only available asset was an interest in their business.

They gave interests in the business to their children and formed a general partnership. The purpose of using a general partnership, as distinguished from a limited partnership, was to allow the children, through their guardian, under the supervision of the court, to participate in the management and control of the business.

The appellees strenuously argued in the lower court that the appellant's alleged desire to give the children security was not credible because as general partners the children's interests would be subject to the business debts. The appellees in arguing this point stressed that the appellants had once been bankrupt. But the appellees and the lower court failed to take into consideration the fact that the heater business had always been profitable under the management of Elgin R. Parker and that it was expected it would continue to be so under his management after 1943. (This brief, p. 3.) It was only the real estate ventures of the appellants which had forced them into bankruptcy and this new partnership was not organized to engage in real estate transactions. It was expected that the heater business would be profitable and the children would build up estates and that those estates would not be subject to the appellants' debts in real estate or other speculative transactions.

The plan has in fact worked out in exactly that manner. The business has been profitable (it was profitable beyond expectations) and the children have estates exceeding \$100,000 each, with income of around \$7,000 per year. (This brief, p. 6.) Hence the appellees and the trial court have missed a significant portion of the factual background; namely, that the heater business had always been profitable and it was their real estate ventures only which threw the appellants into bankruptcy.

This court in *Snyder v. Westover*, 217 F. 2d 928, and in *Pike v. United States*, 231 F. 2d 688, recognized minor children as partners in *general* partnerships. The desire there was to benefit the children and neither the lower court nor this court held that the desire was incredible because as general partners the children's interests would

be subject to the debts of the business. The Government announced that it would not apply for certiorari, in the *Pike* case, 1956 Prentice-Hall, Paragraph 71,086.

There is, of course, no absolute security in this world, as the interests of even limited partners may be washed away; stocks and even bonds may become worthless, shrink in value, or lose their purchasing power.

Appellants gave their children portions of what they had and gave it in the hope and expectation that the assets would produce income in the future as they had in the past. The appellees and the lower court are unreasonable in looking only at the possibility of failure and not at the reasonable expectation of success of the enterprise.

Furthermore, the other objective of the appellants may be realized. The two minor sons are now approaching manhood; one is in junior high school and the other is in college, and both are planning educational programs which would be most useful in the business. The older son is taking a course in Commerce and the younger son in Engineering. This business employs accountants, salesmen, executives and engineers. The commercial and engineering education of these sons would be most helpful to them in caring for and expanding the business in which the family is engaged. It is true that the boys are not absolutely certain yet that they will make this business their lifetime careers, but they feel more inclined to do so because they have an interest in the business and also have a responsibility to their sisters and to their parents in their old age. (This brief, pp. 6-7.) [R. 91.]

Hence, both of the objectives of the appellants are likely to be crowned with success.

The boys have worked in all phases of the business during summer vacations. They talk with their parents about the business and when they finish school they will be well prepared to carry on the business. (This brief, p. 7.)

However, the consuming desire of the parents to provide some security for their children was the paramount motive in making the children partners. This is a legitimate motive.

Flo Parker did not realize any of the tax consequences of the gifts and did not realize that the income tax of the family might be reduced by the division of income. [R. 93.] Elgin R. Parker realized these points but he would have made the gifts even if such had not been the case. [R. 86.] His desire to give security to the children was the paramount purpose in making the gifts.

The trial court recognized that the paramount purpose of the gifts was to give security to the children and that any tax benefit was incidental. At the end of the trial, on commenting on the case, the court said:

> "If the business purpose was achieved, then the fact that incidentally a tax benefit was derived would not destroy the original business purpose." [R. 183, 184.]

(The trial court eventually erred in determining what was a valid business purpose.)

The Commissioner of Internal Revenue in Mimeograph 6767 I. R. B. 1952-1, p. 111, recognizes the same proposition. In paragraph 3, page 117, he says:

> "The presence of a tax avoidance motive, is of no consequence if the reality of the transfer of interest and good faith of the parties are satisfactorily established."

It is submitted that the motive in making the gifts and creating the partnership in this case was legitimate.

In *Snyder v. Westover, supra,* the father made gifts of interests in a business to the children for his own benefit; namely, to assure that he would not lose all of his interest in the business through litigation with his wife. The purpose there was more selfish than the purpose of appellants of benefiting their children, but this court held that there was a bona fide business purpose. In *Nicholas v. Davis,* 204 F. 2d 200, 202 Cal. App. 10, the court said that a similar purpose there was "* * * for a legitimate, and, indeed, a commendable business purpose." In *Pike v. United States, supra,* the purpose of making the children partners was to treat them fairly by giving them interests in a new venture. The gifts were made to the children in order to benefit them. It was argued that they could not have been left out of the new partnership without causing them an injustice. But if there could have been any injustice in leaving them out it would have been because the corporation distributed assets or rights to only part of the stockholders. If the corporation transferred any benefits to the partnership, the Commissioner should have taxed the partnership income to the corporation or taxed the benefits to the adult stockholder partners as dividends and, since he did not do so, it is assumed that the corporation did not give up any valuable rights. Hence the children had no right to receive further gifts of cash and be made partners. However, their capital was needful and useful to the partnership, and was all the business purpose necessary to recognize them as partners.

The desires to give the Parker children some security and to interest them in joining the business are legitimate motives and business purposes.

It is not necessary that the donees render services or contribute additional capital, nor that the business be benefited. (*Snyder v. Westover, supra; Henslee v. Whitson,* 200 F. 2d 540; *House of Representatives Report 586,* 82d Congress, First Session, Section VM (June 18, 1951); *Mimeograph 6767, supra.*) The latter ruling, page 117, says:

> "The Bureau considers that the test of business purpose may be satisfied with the single fact (if it be a fact) that the alleged partner has invested in the business money or property, useful to the business, of which he or she is the real owner under the principles stated in Section 1 hereof even though said property or money had already been used in the business before the alleged partners acquired any interest therein."

On the same page the Bureau says there need be no business purpose for *intra*-family gifts before the donee is recognized for income tax purposes as owner of the property given him. Certainly the facts in the case at bar satisfy the test of legitimate business purpose set out by the Bureau as well as by the Congressional Committees and of this court and the Supreme Court of the United States.

II.

The Children's Capital Was Necessary and Useful to the Business and Produced Income for the Children.

The trial court made findings with respect to capital of the business and of the children as follows:

Finding Number X:

> "All of the capital used in the operation of the business of the Southern Heater Company came from the operations and profits of the company. None of the capital originated from sources outside the business. Neither Flo Parker nor the children contributed any capital toward the operation of the business. The amount of capital in the business was not changed in any way because of the creation of the guardianships or because of the deeds of gift to the children on October 31, 1943. Although Elgin R. Parker ostensibly represented the children as their guardian, he did not operate the business after November 1, 1943, in any manner different from the way it had been operated prior to November 1, 1943." [R. 52.]

Finding Number X is clearly erroneous when it says that neither Flo Parker nor the children contributed any capital toward the operation of the business.

The facts show clearly and without contradiction that as of November 1, 1943, the old partnership had been dissolved and the new one was created. Appellants and the four children owned undivided interests in certain assets and these were contributed to the new partnership, the children contributing 50% thereof and the parents 50%. The finding that the children did not contribute any capital toward the operation of the business is absolutely erroneous. Prior to the contributions, the new

partnership had no assets and no capital but it received contributions from the respective partners. (P. 5, this brief.)

Finding Number XV:

> "During the fiscal years ended October 31, 1945, 1946, 1947 and 1948 the income of the Southern Heater Company was produced entirely as the result of the personal services of Elgin R. Parker and of the capital which the Southern Heater Company had at the commencement of the partnership and which was additionally accumulated from retained earnings. Capital was not a material income producing factor of the Southern Heater Company during the years involved." [R. 53, 54.]

Finding Number XV to the effect that capital was not a material income-producing factor of the Southern Heater Company during the years involved is completely erroneous and is contradicted by the first sentence of that finding which states that the income was produced from the personal services of Elgin R. Parker *and of the capital* which the Southern Heater Company had at the commencement of the partnership and which was additionally accumulated from retained earnings.

Finding Number XVI:

> "All of the income from the partnership business allocated to the guardianship estates for the Parker children was earned by Elgin R. Parker. The partnership made no real change in the economic or financial status of the Parker family." [R. 54.]

Finding XVI is erroneous in that it states that all of the income of the partnership allocated to the children was earned by Elgin R. Parker and that the partnership made no real change in the economic or financial status of the Parker family.

Elgin R. Parker testified that in a manufacturing business it was necessary to have a plant in which the goods were manufactured and that it was necessary to have machinery, inventory and working capital. The goods were sold on credit and the company had to have sufficient money to meet its payrolls and to pay for its materials, taxes and other expenses prior to collection of the sale proceeds. He also testified it was necessary for the company to have cash on hand sufficient to buy steel when it was available, as it was not always available during the war period. (P. 7, this brief.)

The court will no doubt take judicial notice of the fact that a manufacturing business has to have capital and manufacturing assets. This was the uncontradicted testimony in the case at bar.

The statement of facts shows that the business had a capital of approximately $200,000 [R. 163, 164], at the beginning of the partnership and this was increased through retained earnings until at the end of the partnership the net worth of the business was $676,719.00. [R. 133.] The partnership paid its employees the amounts necessary to retain their services and paid Elgin R. Parker a salary of $12,000 a year which was believed to be adequate and reasonable. This was as much as he had obtained from the prior partnership and as much as he had ever earned in working for others and twice as much as the company paid any other executive. While the income of the partnership increased during the war years, it is uncertain whether the increase was due to excellent management or to the war conditions and the luck of the company in getting steel, while many of its competitors were forced out of the heater business, or voluntarily went into war work.

In the complaints and amended complaints appellants offered the court or the appellees the opportunity to adjust, under Mimeograph 6767, *supra,* page 120, Elgin R. Parker's $12,000 salary if they thought it was excessive or inadequate [R. 11, par. XXI, R. 14, par. IX], but neither took any action to do so. The Commissioner of Internal Revenue used it himself for gift tax purposes. (P. 4, this brief.)

Since labor and management have been adequately paid for the services rendered to the partnership, it is obvious that all of the remaining income was due to the capital invested in the business. This is particularly true after April 30, 1946, for after that time the partnership was not active but merely owned land and building which were leased for $30,000 per year net to Southern Heater Corporation, and stocks of the two manufacturing companies. Not much management was required and Elgin R. Parker was paid $200 per month for handling the passive affairs of the partnership. It is obvious that the income from this date on was attributable solely to the capital of the partnership. (P. 9, this brief.)

Prior to that time there could have been some question as to whether the management was inadequately or excessively compensated, but neither the appellees nor the court made any serious objection to the salary paid.

The children contributed to the partnership the capital that was given to them by their parents on October 31, 1943, and they thereafter made original contributions of their retained earnings (p. 8, this brief), as found by this court in *Parker v. Westover,* 221 F. 2d 603, 606. Other courts have held that retained earnings constitute original capital. (*Blalock v. Allen,* 100 Fed. Supp. 867;

Yost v. Commissioner, 190 F. 2d 183 (C. A. 5); *Max Kaplan,* 12 T. C. M. 4.)

The Probate Court approved of this retention of earnings on the ground that the retained earnings were needed for the growth of the business, and so invested were much more profitable than if the money had been invested elsewhere. [R. 97, 137, Pltf. Exs. 13, 14.] The income allocated to the children from the partnership was the income from their capital. It was taxable to the owners of the capital and taxable only to them. This principle has been well recognized by this court in *Parker v. Westover,* 221 F. 2d 603; *Toor v. Westover,* 200 F. 2d 713, 716; *Commissioner v. Brodhead,* 210 F. 2d 652; *Commissioner v. Sultan,* 210 F. 2d 652; *Commissioner v. Eaton,* 210 F. 2d 653; *Snyder v. Westover,* 217 F. 2d 928; *Pike v. United States* (C. A. 9), 231 F. 2d 688, and by the *Congressional Committees,* House of *Representatives* Report No. 586, 82d Congress, First Session, Section VM, June 18, 1951, and by the Commissioner, as shown in *Mimeograph* 6767, CB 1952-1, pages 111, 116, 117. In *Toor v. Westover, supra,* this court held that it was proper to refer to the legislative history of the Revenue Act of 1951 in seeking to arrive at the status of the law for years prior to 1951.

The Supreme Court in *Commissioner v. Culbertson,* 337 U. S. 733, 737, said that Sections 11 and 22(a) of the Internal Revenue Code demand that:

> "* * * he who presently earns the income through his own labor and skill and utilization of his own capital be taxed therefor."

The children owned their interests in the business which produced income and they, and not the appellants, are taxable on such income.

III.

The Children Really and Truly Owned and Controlled Their Property and Income.

The trial court made erroneous findings of fact concerning this point as follows:

Finding Number XVI reads:

> "The partnership made no real change in the economic or financial status of the Parker family." [R. 54.]

Finding Number IX reads as follows:

> "Although Elgin R. Parker, as guardian of the children's estates, filed annual reports with the Superior Court, he exercised sole control in the operation of the Southern Heater Company and subsidiary corporations." [R. 51.]

Finding Number X reads in part as follows:

> "Although Elgin R. Parker ostensibly represented the children as their guardian, he did not operate the business after November 1, 1943, in any manner different than it had been operated prior to November 1, 1943." [R. 52.]

Finding Number XII reads as follows:

> "The creation of the general partnership following the deeds of gift to the children of an interest in a going business affected the titular ownership of the business and the legal form but not the economic substance thereof. The addition of partners after October 31, 1943, had no business effect whatsoever on the operation of Southern Heater Company." [R. 53.]

It will be noted that the trial court made no finding that the children did not actually own their interests in

the business. The court did state that the parents had treated the children fairly in the allocation of their income.

The real views of the trial court, contrary to the findings of fact signed at the instance of the appellees, are shown from comments made at the end of the trial which are found in the record as follows:

> "Each of these cases has its own peculiarities, which have to be considered. There are many elements which have developed in the trial which did not exist in some of the other cases. Perhaps one of the most significant is that there is no general power such as existed in some of the others, of the managing partner to terminate the partnership or make disposition of the profits except in accordance with the general partnership agreement." [R. 182.] (The agreement and the law of partnerships put voting control in the court for the protection of the children—four votes to two for the appellants.) (Matter in parenthesis supplied.)

Later the court said:

> "There is a provision for dissolution at the request of any of the partners [Art. 4 of Pltf. Ex. 3], but that is one of the grounds contained in the law of California which has adopted the Uniform Partnership Law and there is also a provision to which I have alluded before, that other than on dissolution, equal rights existed as to the other partners when it came to transferring interests, that is, a provision is made whereby upon any sale an opportunity be given to the others to purchase within a period, as I remember, of 90 days and other than borrowing money for tax purposes, there is no power in the partnership for the managing partner to treat the minors in any other manner than he himself and

his wife would be treated so that, although the managing partner exercised the general control of any general partner, there is a provision that additional salaries and bonus may be voted, and it provides that it shall be done on the vote of the partners." [R. 182, 183.] (Matter in parenthesis supplied.)

The court also said:

"It is also a fact that so far as the transfer of a partnership interest is concerned, it not only was irrevocable, but has remained such and in one form or another the interests of the minors have continued throughout the minority, and as to the two children who are minors at the present it still continues." [R. 83.] (This is proof of bona fide ownership by the children; not sham.) (Matter in parenthesis supplied.)

Again the court said:

"There are many elements present in some of the other cases, some of which I, myself, have decided, which simply are not present here. One of the most significant ones is that except through failure the father had no way of milking the business, as it were, or even of exacting unreasonable compensation for his services or forcing a sale. All the conditions were equal. Whatever right he had, the others had." [R. 186.] (The purpose of Mim. 6767, *supra*, and the Revenue Act of 1951 was to recognize children as partners when they really own interests in a business, regardless of the motives which actuated the transfer. Senate Report No. 781, 82nd Cong., First Session, Sec. VI A.1.) (Matter in parenthesis supplied.)

"It is true in a sense he dealt with himself, but even a probate court, exercising its advisory duties

> in the most cursory manner could not have allowed, under the wording of the partnership agreement, following the gift, any of the exploitation of the estate of the type which was present in some of the other cases." [R. 186.]

In other words, the trial court recognized that this was a general partnership and that the powers and rights and liabilities of each partner were absolutely equal and mutual. It recognized that Elgin R. Parker, pursuant to sound business policy (*Ardolina v. Commissioner* (C. A. 3), 186 F. 2d 176), took the lead in the management because of his experience and he did so simply as a general partner. The partnership agreement did not give him any special powers or authorities or advantages. (See *Snyder v. Westover, supra,* p. 935.) He had no right to get back any of the property that the parents had given to the children or the income therefrom, either by express provisions or by any other more devious ways. There was no possibility for "kickbacks" and this was not an "Indian gift". There were no "under-the-table" maneuvers but everything was absolutely straightforward and above-board. The substance was identical with the form—there was no "sham". The Probate Court protected the children's property interests.

The father, Elgin R. Parker, as a general partner, operated in a fiduciary capacity as a partner operating for the other partners. Furthermore, he had a second fiduciary relationship as guardian under the supervision of the court. Even as a general partner operating for the others he had a fiduciary capacity which this court recognized in *Toor v. Westover,* 200 F. 2d 713, 715, where this court said:

> "We believe that there is a basic difference between control exercised with unlimited discretion only

> for one's personal benefit, and control exercised only in a fiduciary capacity as a general partner in a limited partnership. See *California Corporations Code* 15,509; 20 *Cal. Jur., Partnerships,* Section 44. This principle has now been recognized by the *Treasury Department, Mimeograph* 6767, 1952-1, *Cumulative Bulletin,* Page 111."

The *California Corporations Code,* Section 15509, provides that the relation of partners to each other is confidential and of a fiduciary character even with respect to general partnerships.

When the trial court in its decision said:

> "* * * the conclusion must be * * * that the business was continued to be controlled by the parents who created it, * * *" [R. 33],

it was ignoring a pronouncement of this court in *Toor v. Westover, supra, Mimeograph 6767,* I. R. B., 1952-1, paragraph 1(d), pages 114, 115, and the effect of the California law on guardianships.

As a matter of fact, under the law the control of the business changed from the appellants to the Superior Court, and thus to the children. No stronger proof could be found of the parents' intention to make the children partners than to give away the control of the business.

It is recognized that the children-donees need not control the business (they may be limited partners, *Marcus v. Commissioner* (C. A. 5), 201 F. 2d 850), it is only necessary that they control their property interests in the business and the income therefrom. They did this through the Probate Court. In Mimeograph 6767, C. B. 1952-1, page 114, it is stated:

> "It is not uncommon in ordinary business relationships for one partner to be made managing part-

> ner or to have voting control, and retention by the donor of control of business management or of voting control standing alone, is of little significance unless the donee either legally or in a practical sense would not be free to withdraw his or her interest whenever dissatisfied with the way in which the business is being conducted * * *"

The Parker children could sell their interests or dissolve the partnership, if their controlling vote through the court did not get them proper management. (P. 10, this brief.)

Since the children became the owners of capital which was useful and necessary in the operation of the business and the children really and truly owned and controlled their capital, the lower court's finding that the partnership made no change in the economic or financial status of the Parker family is completely erroneous. The Internal Revenue Code does not treat a family as a unit but merely treats with individuals. Each of the individuals of the Parker family had his economic and financial status changed by the gifts and by the partnership and hence the family had its financial and economic circumstances changed. The parents were only one-half as well off as they were before, and the children owned a half interest in the business and derived considerable income therefrom, whereas before they had nothing. The appellants supported the children and themselves out of half the income, instead of having all of it subject to appellants' dominion. These factors show a bona fide change of economic status. (*Seabrook v. Commissioner* (C. A. 5), 196 F. 2d 322; *Thomas H. Brodhead,* 18 T. C. 726; *Mimeograph 6767* C. B. 1952-1, 111.)

The recent decisions of this court, as well as the Legislative Record of the 1951 Act and the Commissioner's Mimeograph 6767, make clear that the real issue in these family partnership cases is not the motive or reason why the parents made gifts to the children or whether the parents continued to run the business or whether the children contributed new capital or vital services, but whether the children became the real owners of their interests in the business.

This court recognized that principle in *Parker v. Westover, supra,* where in footnote 4 on page 607, it referred to the legislative history as follows:

> "* * * Your Committee's amendment makes it clear that, however the owner of a partnership interest may have acquired such interest, the income is taxable to the owner, if he is the real owner. * * * Senate Report No. 781, 82d Congress, First Session, Section VI A7 (1951); H. R. Report 586, 82d Congress, First Session, Section VM (1951)."

This court in *Commissioner v. Brodhead,* 210 F. 2d 652, affirmed the decision of the Tax Court in 18 Tax Court 726 on the grounds and for the reasons stated by the Tax Court. The Tax Court, among other things, page 735, said:

> "The attribution of income from property to the owner of the property was emphasized by the tax committees of the House of Representatives and of the Senate in their consideration of the family partnership provisions that became Section 340 of the Revenue Act of 1951. It was the expressed view of the Committees that the partnership income, where capital is a material income-producing factor, should be taxed to the partners if they were the real owners of their interests, regardless of how the interests may

> have been acquired. * * * Nevertheless, the basic principle of taxing income from property to the owner of the property was the law in the earlier years as fully as it is today. * * *" (This principle was pronounced by this court in *Toor v. Westover,* 200 F. 2d 713, 716.)

The Commissioner has announced his acquiescence in the *Brodhead* case, Internal Revenue Bulletin No. 5, dated November 30, 1955, page 7.

The trial court in its decision refused or failed to recognize that there has been any light thrown on the law of family partnerships since the Supreme Court decision of *Commissioner v. Culbertson, supra.* The trial court has refused to recognize the pronouncements of this court on the subject, or the view taken of it by the Congressional Committees, or the admissions against interest by the Commissioner in his *Mimeograph 6767, supra.*

The trial court in its discussion at the end of the trial has clearly shown that it thought that the children were the true owners of their interests in the business and, through the Probate Court, controlled their property and income therefrom and were fairly treated by the parents in that respect. In other words, the court thought that the children really and truly owned their interests in the business.

Courts have given considerable weight to various customary incidents of firm membership which are present in the instant case, such as sharing of losses, *Bratton v. Commissioner* (C. A. 10), 193 F. 2d 416; *Phillips*

v. United States (C. A. 5), 193 F. 2d 132; *Stanchfield v. Commissioner* (C. A. 8), 191 F. 2d 826; the form of bookkeeping employed, annual accountings, audits, and whether there is or will be a pro rata division of firm assets upon dissolution. (*Ardolina v. Commissioner* (C. A. 3), 186 F. 2d 176.)

The court has misapplied the tests as to family partnerships, has erred with respect to the effect of the continued management of business by one of the general partners, has erred with respect to the contributions by the children to the capital of the business and has signed, at the instance of the appellees, findings of fact which contradicted what the court had previously said. The trial court has refused to accept the recent trend in the law established by this court and has insisted upon harsher tests of business purpose than the Commissioner in his own Mimeograph requires and has thus reached a decision which is contrary to the real facts and to the proper application of the law. The children were really and truly owners of their interests in the business and were partners and they should be taxed on their income from the partnership.

As the Supreme Court in the *Culbertson* case, 337 U. S. 733, said, pages 744 and 745:

> "If, upon a consideration of all the facts, it is found that the partners joined together in good faith to conduct a business, having agreed that the services or capital to be contributed presently by each is of such value to the partnership that the contributor should participate in the distribution of profits, that is sufficient."

Conclusion.

We submit that this partnership should be recognized for income tax purposes, within the principles established by the Supreme Court in the *Culbertson* case, by this court in several recent cases, by the Legislative History back of the Internal Revenue Act of 1951 and by the Commissioner's admissions in Mimeograph 6767. The judgments below should be reversed.

Dated: April 4, 1957.

Melvin D. Wilson,
Attorney for Appellants.

APPENDIX.

Section 181 of the Internal Revenue Code of 1939 (26 U. S. C. A.) reads as follows:

"Section 181. Partnership Not Taxable. Individuals carrying on business in partnership shall be liable for income tax only in their individual capacity."

"Section 182. Tax of Partners. In computing the net income of each partner, he shall include, whether or not distribution is made to him * * *"

"His distributive share of the ordinary net income or the ordinary net loss of the partnership, computed as provided in Section 183(b)."

Section 22 of the Internal Revenue Code of 1939 reads in part as follows:

"Section 22. Gross Income.

"(a) General Definition—'Gross income' includes gains, profits, and income derived from salaries, wages, or compensation for personal service (including personal service as an officer or employee of a State, or any political subdivision thereof, or any agency or instrumentality of any one or more of the foregoing), of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *"

Section 3797 (a) (2) of the Internal Revenue Code of 1939 defines a partnership and a partner as follows:

> "The term 'partnership' includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation; and the term 'partner' includes a member in such a syndicate, group, pool, joint venture, or organization. * * *"